

Mind The Gap | August 2020

“As long as poverty, injustice and gross inequality persist in our world,
none of us can truly rest.”

Nelson Mandela

This pandemic is a ‘pain in the you-know-what.’ It has disrupted our lives with all sorts of new protocols and practices, and taken some pre-existing trends, i.e. work from home, and hyper-accelerated them.

Unfortunately, one such accelerated trend is the growing divide between the haves and the have nots, with pandemic hardships disproportionately falling on lower-income and marginalized groups.

Even before the pandemic, 70% of Canadians were pessimistic about closing the gap between the rich and the poor (Pew Research 2019). And in January, the IMF’s Managing Director referred to inequality as “one of the most complex and vexing challenges in the global economy.”

The expectation is for the situation to get worse. In a recent survey of top economists, over 90% felt the pandemic will lead to greater inequality. A view supported by historical evidence.

As per a recent IMF study, “if past pandemics are any guide, the toll on poorer and vulnerable segments of society will be several times worse” (2020, Ostry et al). Their analysis showed how previous epidemics increased the income gap and damaged the job prospects for those with basic education, while scarcely affecting those with advanced degrees.

Thus far it appears COVID-19 is following this pattern. On top of higher risk factors and less access to resources, lower-skilled workers and minorities have also faced the brunt of the recent spike in unemployment.

If we are to reverse the inequality trend, we need to address this massive loss of job opportunities. Beyond a paycheck, work offers multiple benefits to the individual, their family, and the community.

This is why for so many, full employment, when anyone who wants to work can, is the ultimate goal. How to achieve it, is the big question. A question which may be getting a pandemic rethink, if the Fed’s virtual Jackson Hole meeting is any indication.

The Federal Reserve has a dual mandate, which includes maintaining low and stable inflation and creating conditions for full employment. For the last 40 years or so, the focus has been on inflation, and in particular inflation expectations.

For much of this millennium, they have managed monetary policy to keep inflation at 2%. The few times it threatened to breach that level, the Fed responded by pre-emptively raising interest rates, and as a by-product increased unemployment.

The shift at their August meeting was to adopt a flexible average inflation targeting strategy. This allows them to let inflation run above 2% to offset periods when it is below (i.e. the past decade). Thus enabling them to focus on increasing broad-based employment and be more patient with rate hikes.

The Bank of Canada is also looking closely at how it manages monetary policy to achieve low and stable inflation (2%). Their approach is described as ‘flexible inflation targeting,’ that in practice looks similar to the Fed’s average inflation methodology. While we don’t expect the BoC to change its course of action until much further into the recovery, they could announce changes to their current philosophy.



We are encouraged to see this policy rethink, as it could be a powerful tool to combat inequality. And as members of society, we are hopeful that along with other initiatives these shifts can help close the gap. But as fixed-income nerds, our more immediate task (and value to the reader) is to evaluate their impact on the bond market and the macro-environment.

Our interpretation of the central bank messaging is that short-end rates should remain stuck where they are for quite some time. North American central bankers are certainly not in any hurry to hike, and after studying the efficacy of negative rates in Europe and Japan, they are reluctant to go below zero.

The greater uncertainty lies around longer-maturity yields, where the central banks have less control. If as the Fed indicated, they are willing to let inflation run hotter than 2% it makes sense for investors to want higher compensation to own longer-term debt.

So far, there has been little reaction in long-end rates as the central bank purchasing programs have skewed the market and depressed yields. But should these programs taper or the economic recovery gathers steam, 10y rates at 0.55% might be unacceptably low.

Thus, we see the shift in policy leading to the potential for steeper interest rate curves: very low in the short-end with the upward pressure on the long-end. This is good news for short-term borrowers, not so good news for savers, and as for long-bond investors, our advice is to mind the gap.

The Fund Performance.

August 2020.

As expected, August was quiet with very few new deals and reduced trading activity. Credit spreads began the month grinding tighter before levelling off in the second half. High-beta sectors, such as autos, REITs, and pipelines outperformed due to improving fundamentals (i.e. recovery in auto sales) and the reach for yield.

Generic Investment-Grade Credit Spreads

- Canadian spreads tightened 8 bps to finish at 131 bps
- US spreads tightened 4 bps to finish at 129 bps.

The US market slightly underperformed last month due to a larger amount of new supply, in an already record year. North of the border, the Canadian market printed \$5 bn, versus August norms of \$6 -7 bn.

- Notable deals were the three Brookfield entities, Brookfield Properties, Brookfield Infrastructure, and Brookfield Renewables. Husky Energy, Bell Canada, SNC-Lavalin, MCAP, Canada Western Bank, and First Capital also accessed the market.
- It is interesting to note that in the early stages of the pandemic, most of these companies were unable to issue debt at reasonable levels. Last month they were able to come to market with no price concessions. Despite this, the deals were so well received that even their secondary bonds rallied.



Canadian banks reported results last month, with surprisingly strong numbers driven by capital market activities.

- Results were boosted by fees from the massive amount of bond issuance this year, trading profits, and robust equity markets, coupled with low funding requirements.
- Another driver was low PCLs (provisions for credit losses). This indicates that bankers are optimistic that the improving economy translates into lower future loan losses.
- Despite the losses incurred thus far, reported capital levels are strengthening.
- Lastly, the banks continue to enjoy the support of regulatory, fiscal, and monetary stimulus measures.

The Fund benefitted from outperformance in individual credits and sectors, with the greatest contributions coming from banks, REITs, and pipelines. Thus, despite a quiet month and limited trading opportunities, the Fund finished August with a strong return of 2%.

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	2.00%	10.59%	-0.67%	0.15%	3.55%	4.09%	9.21%	10.00%
F Class	1.98%	10.45%	-0.90%	-0.21%	2.81%	3.34%	NA	NA

As of August 31st, 2020

The Algonquin Debt Strategies Fund LP was launched on February 2, 2015. Returns are shown on 'Series 1 X Founder's Class' since inception and for 'Series 1 F Class' since May 1st, 2016 and are based on NAVs in Canadian dollars as calculated by SGGG Fund Services Inc. net of all fees and expenses. For periods greater than one year, returns are annualized.

Looking Ahead.

After a quiet summer, we anticipate market activity and volatility to pick up in the fall.

- The US election certainly has the potential to create some market indigestion. The rhetoric from the campaign trail, poll updates, delays in mail-in voting, and of course, the ultimate result, will add some volatility and trading opportunities.
- Narrower spreads and ultra-low rates translate into low all-in borrowing costs for issuers of all stripes. The combination of attractive funding levels, receptive investors, and a desire to avoid any US election silliness raises the odds of higher issuance activity in the coming weeks.



- Canadians await the throne speech later this month, which could drive the domestic political agenda for the remainder of the year. It should also provide clarity on the fiscal stimulus plans going forward. The economic fallout from the government proposals could have implications on yields and credit spreads.
- With economies and schools continuing to re-open and the winter flu season upon us, the potential for a spike in COVID-19 cases could negatively affect the recovery.
- Vaccine developments, both positive and negative, will continue to have an outsized impact on the market, as we lurch from headline to headline.

In anticipation of the fall volatility, we have reduced exposure and rotated from a medium risk posture to low-medium. From this position, we can purchase high-quality corporate bonds and add exposure on market weakness.

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